Lugarno Fund

INVESTOR LETTER
30 June 2021

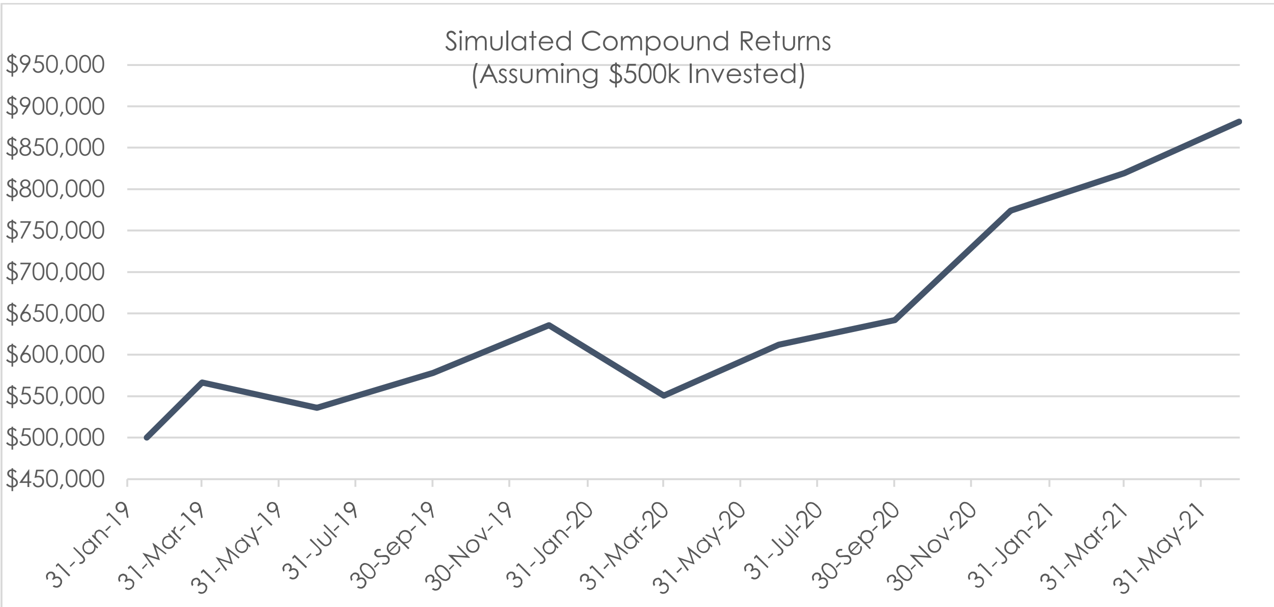
29 July 2021

Dear Partners,

The returns for the Lugarno Fund as at 30 June 2021 are as follows:

3 months	12 months	Since inception
7.61%	**43.99%**	**27.35% pa**

The fund began on 15 Feb 2019 and has provided a return of 27.35% pa (after all fees and costs) since its inception. If you had invested $500k in the Lugarno Fund at inception, it would now be worth $881,459.



"Chess masters know that to win you have to avoid losing. The first thing they do after an opponent makes a move isn't to think about strategy or winning but rather ask themself: what's the threat? Avoid stupidity before seeking brilliance" Shane Parrish

COMMENTS

Portfolio comments

At the time of writing this note, approximate composition of the portfolio was as follows:

- 11% in cash or cash-like securities
- 23% invested in private investments
- 66% invested in listed companies of differing size and region
- 72% of the portfolio was invested in the funds six largest investments

Significant contributions were:

- Litigation Capital Management rose 50% this quarter for no obvious reason. LCM is a litigation funder and we believe the matured value of their current investments is worth in excess of the market cap. This provides sufficient margin of safety allowing us low risk exposure to the company's significant growth potential.

- Scorpio Tankers rose 21% this quarter. Scorpio is the world's largest owner and operator of product tankers. Its share price appeared to rise because the market sees Scorpio as a beneficiary of the global economy re-opening – we think this is just one aspect of the opportunity. The stock is still selling at a discount to NAV and we believe the product tanker market has a demand/supply dynamic to support rates for a few years to come.

- Macquarie Infrastructure Corporation rose 23% this quarter. The company announced the sale of its third (and last remaining) asset. This concludes an almost 2 year process to sell its operating businesses. We expect all of the cash proceeds to be distributed in the next 6 months.

- Acrux Ltd declined 18% during the quarter despite the company announcing yet another positive milestone. Frustratingly, the market is either ignoring, misunderstanding, or totally unaware of the company's progress.

- Bailador Technology Investments declined 10.5% during the quarter. We suspect the weakness was attributed to their capital raising in April. The stock is trading at a discount to its NAV and we are confident BTI management will continue to build value overtime.

Bias to recent events

Humans have a habit of overweighing recent experiences, this is particularly true of investment results. Jason Zweig's recent article in the WSJ suggests that US investors expect to make a whopping 17.3% over the next 12 months.

I'm sure we can all recall a recent conversation with someone expressing over-confidence around their investment ability. This is typical during bull markets and vice versa following a market correction.

"After seeing a movie that dramatizes nuclear war, they worried more about nuclear war; indeed, they felt that it was more likely to happen. The sheer volatility of people's judgement of the odds--their sense of the odds could be changed by two hours in a movie theatre--told you something about the reliability of the mechanism that judged those odds." Michael Lewis

Being over-confident at any time is dangerous especially when it is founded on recent success. Given the cyclicality of investment markets, is it not more logical that a winning streak brings us closer to a period of weaker returns?

Focus on what we can control

A share price is simply the result of a vote. A short-term forecast is tantamount to guessing the opinions, moods and unique circumstances of thousands of other people. Investors (especially new ones) struggle to recognize the immense margin of error in short-term forecasts.

So if we have little (no) control over short-term results, why place any specific expectations on them? *"Expectations outside of reasoned choice leave you fragile, rigid, and reactive"* Alex J Hughes in the Daily Stoic.

Jeff Bezos is well-aware of the psychological impact of investment returns. He advises his staff to ignore short-term movements in Amazon stock... "When the stock is up 30% in a month, don't feel 30% smarter. Because when the stock is down 30% in a month, it's not going to feel so good to feel 30% dumber."

By removing expectations we are better able to focus on repeating the types of decisions which we are confident will deliver us our objective, that is, to max out returns while avoiding any permanent capital losses.

I know this statement is on repeat but it's important. We measure our effectiveness over a 3-5 year period and we are grateful that you (our investors) provide us the slack to do so. Your patience is our competitive advantage.

Now is the time for caution - not over-confidence

It is true that we would love this streak to continue. Strong returns provide a utopic sensation that is addictive. Have you ever noticed that you check your share prices more often when your portfolio is up?

We humans have a tendency to be over-confident anyway. Charlie Munger quotes Demosthenes "what a man wishes, that also will he believe". There is a force that drives people to believe the stock market, casinos or lotteries is a source of quick riches. Being aware of our inclination to be over-confident is helpful – especially today.

Strong returns are a trap. Because they feel so good, we get a false sense of security which can blind us. It is well understood that investors are far more risk averse following a large correction. It's important we recognise the opposing effect of a bull market. Now, more than ever, we need to be cautious.

Despite the short lived (COVID) correction, we have enjoyed a 12 year bull market. Given we are clearly at the market's historical extremes, it seems reasonable to us that we are nearing the end of this fabulous run (at the very least we are closer to the end than the beginning).

Despite this we are witnessing an unprecedented bias to risky investing. This optimism is being fuelled by low interest rates and an expectation the good times will just keep on rolling. News flash – they won't.

A colleague suggested he would gladly borrow at 8% to invest. They suggested that generating a return of +15% is 'easy'. Humans have a habit of confusing returns achieved in the short-term, with long-term incompetence.

“Only when the tide goes out do you discover who’s been swimming naked” – Warren Buffett

We have all had a great time over the past decade being rewarded handsomely for almost any financial decision we make. Instead of extrapolation, let us do more consolidation.

On a ride last weekend I didn’t pack my spare tyre. My saddle bag had broken and it was inconvenient to hold the spare on me. I hadn’t had a puncture in a year so I was feeling lucky. Needless to say, I got a puncture and my lacklustre approach to an obvious risk cut my ride short.

Warren Buffett’s success was not determined by any single result, rather his ability to protect and compound over decades. It’s relatively easy to make money in the good times but extremely difficult to do it across multiple cycles.

This period of easy returns has attracted all kinds of people to the investing game. The proportion of the population owning shares is the greatest it has ever been – a typical feature of any late stage bull market. What is also typical is that when the tide eventually turns, there will be less investors.

The question I regularly ask myself is whether we will be one of those washed away, or, one of the few left standing? Our priority is to protect and grow. One objective doesn’t survive without the other.

I’m confident that the principles set out in these letters will achieve that for us.

____

Acknowledgements: Shane Parrish, Charlie Munger, Alex Hughes, Jeff Bezos, Michael Lewis.

THE FUND

We believe in the concept of skin in the game – we eat our own cooking.

This fund serves as the primary investment entity for my family's wealth so you can be confident we are treating your investment like it's our own.

This fund exists to generate solid returns and if we fail to do so we do not deserve to be in business. We do not charge a management fee and only earn performance fees if we achieve returns of greater than 6%. This fee structure is a clone of Warren Buffett's early partnership.

We believe that the easiest way to grow capital is to avoid losing it. In practice this means that investments require a large margin of safety between what we pay and the value we believe we are receiving. We also prefer companies with substantial tangible assets to protect us should things not go to plan.

Good investment opportunities are rare so when they come along, we are willing to invest significant amounts of the fund's capital to maximise the investor's benefit. Conversely, we are content holding substantial cash in the absence of valuable opportunities.

In order to consistently make good decisions, we cultivate a sceptical and contrarian mindset. It is statistically impossible to generate great returns by investing with the same lens and conventional wisdom of 'Mr Market'.

Our investment strategy looks to capitalise on two main elements of the investment market place.

- Inefficient distribution of information: This is where under-researched companies are much less understood by the broader market
- Over-reaction tendency: This is where investors act in herd-like behaviour by over-reacting to negative news on otherwise quality investments

Well known opinions are usually priced into stocks and so we find that ideas are only valuable if they are contrary to consensus.

Internally, we judge our performance over periods of at least three years and we ask you do the same. While we strive to identify near term catalysts for our investments, 'Mr Market' rarely agrees with our perspectives as fast we would like.

We believe wealth gives people the freedom to live their best life and we are immensely proud to get to work every day helping you with that.

FUND PARTICULARS

Trustee	DDH Graham Limited
Investment Manager	Lugarno Partners Pty Limited
Administrator	DDH Graham Limited
Auditor	Findex
Min. investment amount	$250,000
Min. investment term	2 years
Redemptions	90 days' notice
Ongoing fee	Zero management fee
Performance fee	Performance fee of 25% above a hurdle of 6%, subject to a high watermark
Buy/sell spread	0.5% of applications and redemptions
Fund operating expenses	Capped as the higher of $50k or 0.5%

For investment enquiries:

Simon Harradence
0414 922 742
simon@lugarnopartners.com.au

For administration or application enquiries:

Julia Portus
0428 902 689
julia@lugarnopartners.com.au

This update contains information concerning about the Lugarno Fund (Fund), an unregistered managed investment scheme, and has been prepared by Lugarno Partners Pty Ltd ACN 607 035 138 AFSL no. 508934 (Investment Manager) as investment manager of the Fund. DDH Graham Limited ACN 010 639 219 AFSL no. 226319 (Trustee) is the trustee of the Fund. This update is for distribution only to wholesale clients as defined in section 761G of the Corporations Act and to sophisticated investors under section 761GA of the Corporations Act. It contains general information only and is not intended to provide advice to any particular investor, nor take into account an individual's investment objectives, circumstances or needs.

Returns shown are net of all fees and costs. Past performance is not indicative of future performance. This update also contains statements about the estimated future performance of the Fund, which are based on a number of assumptions that may not prove to be correct or appropriate. Actual performance may vary from estimated or forecast performance. Neither the Investment Manager nor the Trustee give any representation, assurance, guarantee or warranty that the estimated return or any projection, forecast or assumption contained in this document will actually occur.